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TREASURY FOR OASIA - JLEICHTER AND MMILLS
NSC FOR MBRYZA AND TMCKIBBEN

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TAGS: EFIN ECON PGOV TU
SUBJECT: AGREEMENT WITH IMF ON DRAFT LETTER OF INTENT, CENTRAL BANK CUTS RATES

REF: A. ANKARA 1319
¶B. ANKARA 1578

¶1. (Sbu) Summary: Deputy ResRep confirmed to Econoffs that the IMF and GOT have reached agreement on a draft letter of intent (LOI), with only minor follow-up steps needed for the GOT to sign the actual LOI. Not coincidentally, on March 17 the Central Bank cut overnight interest rates by 2 percentage points. Two-thirds of the fiscal gap was filled from expenditure reduction and one-third from increased excise tax revenues on tobacco, alcohol, petroleum products, and liquified petroleum gas. After much discussion, natural gas and electricity taxes and prices were not increased. The Deputy ResRep admitted the quality of the fiscal adjustment was not good, but said there were few near-term alternatives to the measures taken. The GOT has also committed to promulgate bankruptcy regulations, appoint the head of a commission to study the Imar Bank failure, and take steps towards state bank privatization. The IMF program will have only three more reviews, each with a $660 million disbursement, with the final board vote scheduled for January
¶2005. The GOT seems increasingly open to an IMF role after
¶2004. End Summary.

Agreement Reached on a Draft LOI:

¶2. (Sbu) In a March 16 meeting, IMF Deputy Resident Representative Christoph Klingen confirmed press reports that the recently-departed Seventh Review Mission had reached agreement with the GOT on a draft LOI. As with past reviews, Klingen said there were some follow-up actions the GOT needed to take before they could finalize the LOI, but that these were not major.

¶3. (Sbu) Klingen specified that, other than some minor procedural actions, the GOT needed to take three steps before the Seventh Review could go to the IMF Board: appoint the head of a commission to study the Imar Bank collapse, a longstanding IMF demand; withdraw capital from state-owned Ziraat Bank, and, depending on the structure of the planned Halk Bank-Pamuk Bank merger, from Halk Bank; and promulgate regulations implementing the new bankruptcy law passed by parliament in February.

End-game of the Fiscal Gap Saga:

¶4. (Sbu) After months of complex negotiations over measures to close the fiscal gap, the Fund and GOT finally agreed to a package with two-thirds of the gap made up from the expenditure side and one-third from increased revenues. As previously reported, the gap was opened by a combination of shortfalls in 2003 and the Prime Minister's decision to increase the minimum wage and pension payments. Klingen specified that the Fund stuck with its estimate of a TL 7 Quadrillion (about 1.75% of GDP) gap, declining to get into a debate over the appropriateness of its estimate. Klingen said the GOT still did not have final 2003 data for the entities outside the Central Government. For the Central Government the 5 percent primary surplus target had been slightly exceeded, but when final numbers are available for the Consolidated Public Sector the Fund expects a primary surplus of 6.2 percent of GDP, a slight shortfall from the 6.5 percent target.

¶5. (Sbu) On the spending side, the gap-filling measures totalled TL 4.4 Quadrillion, according to Klingen, with TL 3.9 Quadrillion from the 13 percent across-the-board cut in discretionary spending, and TL 500 Trillion in earmarked spending from the Special Revenue accounts. Klingen said these accounts, which are being brought on-budget by the Public Financial Management on Control Law, consist largely of university and other school expenditures, drawing on earmarked school fees.

¶6. (Sbu) On the revenue side, Klingen shed light on the ever-changing and sometimes contradictory press reports. In the end, the package includes increased tax revenues from tobacco products, petroleum products, alcohol, and liquid petroleum gas. In recent weeks, Energy Minister Guler had repeatedly denied press reports that natural gas and electricity prices would be increased, and Klingen confirmed that natural gas and electricity were not in the final package. He said the Fund had advocated inreased excise taxes on natural gas. In the end, Klingen said the GOT had pushed for only raising taxes on Liquified Petroleum Gas (LPG), because LPG prices had fallen 25 percent on international markets such that the GOT could more easily assess higher taxes. He said the IMF had reluctantly agreed, subject to review in six months. Klingen pointed out however, that the budget assumed natural gas prices would rise over the course of 2004 in line with projected wholesale price inflation, so the GOT may need to raise gas prices later in the year.

¶7. (Sbu) Klingen explained that the revenue increase from tobacco derives from price increases rather than a higher tax rate. The additional revenue from tobacco products is expected to be about TL 1.1 Quadrillion. He said that with most of the end price to the consumer deriving from VAT and other excise taxes on tobacco products, a price increase has a significant tax collection impact. Klingen confirmed that the Fund's initial idea of increasing tax rates had led to GOT fears that state-owned Tekel might be hurt if its private competitors did not fully pass on the tax increases to customers. The GOT solved the problem by "talking to" the private companies and getting them to raise their prices. Klingen admitted this was not an ideal approach but was one of the compromises the Fund went along with. Klingen added that the IMF insisted that in August, any end-user price increase will come from increasing excise taxes rather than prices.

Quality of Fiscal Adjustment:

¶8. (Sbu) Klingen admitted that the quality of the fiscal adjustment was "not good." He argued that the GOT decision to raise the minimum wage and pension payments had left few good options in the short run. Over a longer time horizon, the Fund was working on improving tax collection. Klingen said the GOT is also due to have a Public Expenditure Review under its IFI programs. Though normally conducted by the World Bank, the IMF felt the review should not wait and is taking the lead on an initial review in the coming months, followed by a fuller World Bank-led review later in the year.

Banking Issues:

¶9. (Sbu) Klingen said the LOI specifies an ambitious schedule for the revisions to the Banking Act, calling for the introduction to parliament before the summer recess. The changes would provide for better coordination between off- and on-site bank inspection, immunities for BRSA and SDIF staff for their official acts, and a tightening of the "fit and proper" criteria for bank owners. Klingen said the Fund now has more faith in BRSA Chairman Bilgin. The new SDIF leadership seems to be moving in the right direction, but Klingen said that the Fund's Bank experts have doubts about the SDIF leaders' competence. Regarding the continued attempts of failed bank owners to come back into the banking system, Klingen said IMF M.D. Kohler had warned Prime Minister Erdogan about the Demir Bank case, and that the delay in the Court of Accounts' decision on Demir may be a positive sign. Klingen said the Fund is monitoring Cukurova Group, who might try to play newly-separated BRSA and SDIF off against each other.

¶10. (Sbu) Klingen said the Bankruptcy legislation was a

longstanding IMF requirement and that bankers had fought a provision spelling out the mechanism for a pre-packaged bankruptcy feature facilitating out-of-court settlements. The bankers believed that if the law got too specific about the mechanism it would undermine banks' leverage in debt workouts. According to Klingen, having lost the battle over the legislation, bankers might try a rearguard action on the implementing regulations, hence the IMF's requirement that the regulations be announced before the IMF Board vote.

Fewer IMF Reviews:

¶11. (Sbu) With the schedule of reviews pushed back by the delays in the Fifth, Sixth and Seventh Reviews, the IMF and GOT agreed to shrink the number of reviews remaining under the existing Standby. Instead of five, there will be three more reviews, with each releasing a $660 million--rather than $500 million--disbursement. Klingen said the final review would be negotiated in December but would not go to the Board until January 2005.

Post-program IMF role:

¶12. (Sbu) Klingen said the GOT is showing increasing signs of accepting an IMF role beyond the end of the Standby. At a minimum, IMF rules require a post-program monitoring arrangement for countries having borrowed over 100 percent of their quota. In Turkey's case, Klingen said the Board would probably require three or four reviews a year under such an arrangement. One step up from such post-program monitoring would be a Precautionary Standby. Klingen said Babacan has said the GOT will take a decision in mid-year.

Central Bank Cuts Rates:

¶13. (Sbu) Undoubtedly because of the agreement with the IMF, the Central Bank announced a 200 basis point rate cut March ¶17. The Central Bank's press release said nothing about the IMF, but highlighted the importance of fiscal policy complementing monetary policy, and even sounded a Greenspanesque note favoring spending-side cuts over tax increases. Many private analysts have been saying for some time that a rate cut is overdue based on fundamentals, and the markets had clearly priced in the cut: rates on government securities hardly budged after the Central Bank announcement. The timing, coupled with Governor Serdengecti's frequent private comments to econoffs about the need to maintain pressure on the Government over fiscal policy and the IMF program, suggests the Bank waited for agreement on a LOI to announce the cut.

EDELMAN